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JAPAN AS AN INTERNATIONAL CREDITOR: NEW ECONOMIC AND POLITICAL REALITIES

Summary

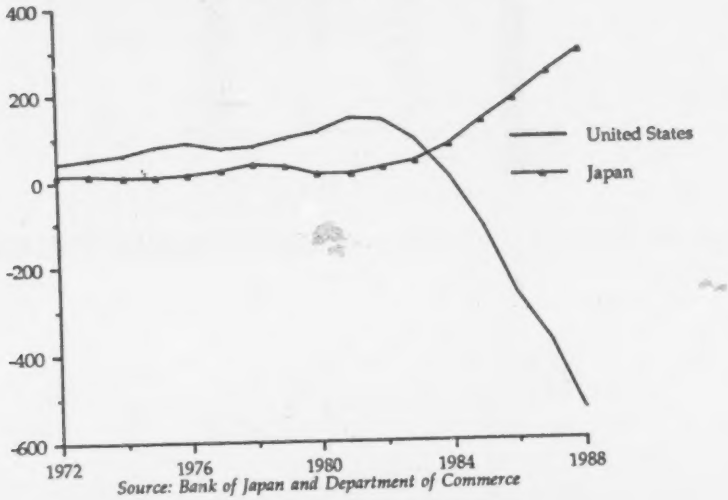
Japan is now the world's largest creditor. This means that Japan's government and Japanese firms and individuals now are owed on balance more money by nonresidents than comparable groups anywhere else in the world. The United States, which as recently as 1981 enjoyed the distinction Japan now holds, finds itself in exactly the opposite situation as the world's largest debtor. The change in the status of the two countries raises the obvious question as to whether Japan has reached its current position at the expense of the United States. While the two phenomena are related, the relationship is more complicated than one country gaining at the other's expense. Whatever the economic linkage, the political implications of this near role reversal are only beginning to be discussed on either side of the Pacific. But in this instance as well, the prospects are more complex than they appear at first glance.

Sources of Japan's International Creditor Position

As 1984 dawned the United States was a larger net creditor than Japan, but, as the Figure shows, Japan's international creditor position began climbing about that time. Many other industrial countries share Japan's status as a net creditor, even if their net position is not as large. For example, the Department of Commerce estimates that West Germany had net assets of $195 billion and the United Kingdom $150 billion in 1988, making their combined worldwide position larger than that of Japan for which the comparable figure was $292 billion. Similarly, the net assets of Western Europe in the United States last year were more than three times as large as Japan's $129 billion. Moreover,

Net International Investment Positions

(in billions of dollars at yearend)



Source: Bank of Japan and Department of Commerce

the figures for the United States probably understate the true value of U.S. foreign assets, including gold, and therefore are too pessimistic concerning the extent of the U.S. debtor position. However, they most likely correctly represent the decline in the U.S. net position.[1]

Just as the international debtor position of the United States grows out of its domestic economy, so does Japan's role as the largest international creditor. In Japan, as elsewhere, households, government and business are all potential users and suppliers of funds in the form of savings. By definition, sources of funds equal uses of funds. If, as has been the case with Japan in recent years, domestic uses are less than domestic sources, the extra savings are represented (except for a small statistical discrepancy) by the flow of funds abroad. Conversely, if domestic savings are less than the uses of funds, as has been true of the United States in recent years, the country experiences a capital inflow. Countries with an outflow over many years, such as Japan, eventually develop large international creditor positions, while countries like the United States become large debtors.

Trade deficits and surpluses are another way of describing the same phenomenon. Nations engaging in international trade have to settle the imbalance in some way. One way, analogous to a consumer running up charges on a credit card, is to go into debt, which the borrower eventually may have to repay. Nationals of one country, once induced to accept the currency of another in payment, in effect agree to accept an IOU they later can use to purchase the goods of the debtor country. That is, net changes in the level of IOUs and other borrowing exactly equal the trade imbalance of a given country over a specific period.

[1]For details of this argument, see Sarah A. Hooker, The International Investment Position of the United States (Washington, D.C.: National Defense Research Institute, October 1988).

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Thus, while net borrowing equals the trade imbalance, it also, as indicated earlier, equals surplus savings. Therefore, the international flow of funds, the current account balance and the surplus or shortfall of savings are three ways of representing the same phenomenon.

While these concepts are inextricably linked, experts disagree about what causes what. The arithmetic relationship tells us nothing about whether trade imbalances create savings imbalances or whether it is the other way around. However, many experts believe that the government's net demand for funds is an identifiable independent factor in the equation. As such, increases in the budget deficit in the United States, for example, deserve serious consideration as causal factors for the trade imbalance and the corresponding capital inflow into the United States. Similarly, most economists believe that Japan's high personal savings rate is more of a cause than an effect of the other factors in the equation. However, unlike the U.S. budget deficit, the Japanese savings rate changes relatively little year by year. Thus, the budget deficit is a leading candidate to explain the explosion during the early 1980s of the U.S. current account deficit and its probable persistence into the 1990s.

Table 1 gives some indication of how these factors have evolved for three of the largest trading countries -- the United States, Japan and West Germany. By broad measures of government spending in 1979 the United States had a small budget surplus and virtual balance in its current account. Japan

Table 1: Current Account and Government and Private Domestic Imbalances

(percent of GNP)

	1979	1982	1985	1987	1988
Japan					
Current Account	-0.9%	0.6%	3.7%	3.6%	2.8%
Fiscal Balance*	-4.7	-3.6	-0.8	0.6	1.3
Private Net Savings**	3.8	4.2	4.5	3.0	1.5
United States					
Current Account	0.0	-0.3	-2.9	-3.4	-2.8
Fiscal Balance*	0.5	-3.5	-3.3	-2.3	-1.8
Private Net Savings**	-0.5	3.2	0.4	-1.1	-1.0
West Germany					
Current Account	-0.7	0.8	2.6	4.0	4.0
Fiscal Balance*	-2.6	-3.3	-1.1	-1.8	-2.0
Private Net Savings**	1.9	4.1	3.7	5.8	6.0

*Central and local governments.
**Gross savings in business and household sectors minus gross investment in business and household sectors.

Source: Bank for International Settlements

and West Germany, by contrast, had budget and balance of payment deficits. In the early 1980s the U.S. budget deficit turned sharply negative, with corresponding changes in the current account. Tokyo and, to a lesser extent, Bonn reduced their budget deficits, and the two countries moved to large surpluses in their trade accounts. Since 1987 the trade account in Japan has declined as a percentage of gross national product despite continuing progress in reining in government spending, while the imbalance rose in West Germany between 1982 and 1987 and stayed at 1987 levels last year.

Another interpretation of Table 1 is that Japan's international creditor position grew rapidly in the mid-1980s but is now rising more slowly, at least temporarily, as measured in yen relative to the domestic Japanese economy. However, Japan's economy continues to grow rapidly and, at least between late 1985 and 1987, its currency appreciated; both economic growth and the yen's appreciation tended to inflate the dollar-denominated capital outflow. For these reasons, the growth in Japan's international creditor position looms large relative to the U.S. economy, even while it appears to be shrinking relative to the Japanese economy.

Table 2 gives some details of how Japanese sectoral financial demands contributed to the relatively smaller capital outflows from Japan in 1987 and 1988. As Japanese experts have been at pains to explain to American audiences, the answer is domestic demand. Surging plant and equipment spending by corporations, coupled with healthy housing expenditures by consumers, widened the deficit of funds in the corporate sector and reduced excess savings by households, more than offsetting the diminishing demand from the public sector. (In Table 2 the rest of the world sector corresponds approximately to Japan's current account but with the signs reversed. It shows a negative balance because this sector is a net user of funds provided by domestic sectors.)

As a result of these flows, the United States and Japan find themselves in opposite situations regarding the relationship between expenditures and pro-

Table 2: Financial Surpluses and Deficits in Japan by Sector

(in trillions of yen)

	1981	1982	1983	1984	1985	1986	1987	1988
Incorporated Businesses	-Y7.8	-Y10.3	-Y8.5	-Y5.1	-Y6.0	-Y4.3	-Y7.7	-Y16.9
Households	28.1	29.0	29.0	29.3	31.1	33.8	27.3	27.8
Public	-18.7	-18.6	-19.0	-17.3	-13.2	-13.8	-4.8	2.2
Financial	-0.5	1.7	3.5	1.5	-0.5	-1.5	-2.3	-2.8
Rest of World	-1.1	-1.8	-5.0	-8.3	-11.5	-14.2	-12.5	-10.2

Source: Bank of Japan

duction. The United States like any deficit country creates a potential future international liability for itself. As such, Americans now enjoy high present levels of expenditures at the cost of future living standards, other things being equal. However, if the United States manages to use the borrowed funds for greater capital spending and other investment than otherwise would be possible, it may be able to increase its productive capacity enough to avoid a long-run drop in living standards as the bills come due.

Conversely, if Japan -- because of trade restraints, exchange rate manipulation or high savings -- manages to run a chronic trade surplus, in effect it acts in support of extraordinary expenditures among its trading partners at the cost of its own living standards. In the long run it can hope to be repaid, with interest. For Japan, which is concerned about its rapidly aging population, current account surpluses in the late 1980s may be a way of preparing for a reverse flow early in the next century when productive capacity may be much lower relative to consumer demand than it is today.

Causes of Japan's International Capital Flow

As indicated above, most experts believe that America's federal budget deficit has played a major role in creating an inflow of capital to the United States. As Washington's demand for funds grew in the 1980s, interest rates rose from the levels they otherwise would have reached, attracting more foreign funds to this country. Money was pulled into the United States from all over the world, not just Japan, as evidenced by the current account deficits the United States has had in the late 1980s with Western Europe, Latin America and Asian countries other than Japan.

But if the budget deficit here exerted a mighty pull, factors in Japan combined to push the funds out. One already mentioned was high savings. At least during the postwar period, household savings rates in Japan have been among the world's highest. The rise in the U.S. budget deficit coincided with factors that made it likely that this savings pool would be mobilized in the financing of the U.S. budget deficit, directly or indirectly. As noted above, the demand for savings in Japan was increasing only slowly since government budget deficits were on the decline and the needs of the corporate sector were modest, at least until recently. Thus, the supply of savings increased as the savings rate held relatively steady and the economy grew.

At the same time, investing overseas became easier. Changes in Japan's Foreign Exchange and Foreign Trade Control Law in 1980 made unrestricted international capital flows the rule rather than the exception, which most, but not all, observers believe enhanced the attractiveness of investment abroad. The pace of change has accelerated in recent years. Changes in provisions since 1984 relating to outbound capital flows include the following:

- In April 1984 the "real demand rule" that required substantiation of the need for a forward exchange transaction was removed, yen-denominated loans to nonresidents were liberalized and the guidelines and qualification standards for samurai bonds were relaxed, among other changes. (Samurai bonds are a way for foreign firms to raise money in the Japanese market and, therefore, a means of facilitating outbound capital flows.)

- In December 1984 and again in April 1985 guidelines and qualification standards for Eurobond issues by nonresidents were relaxed.

- In April 1985 Euroyen loans with maturities over one year for nonresidents were liberalized.

- In April 1986 Euroyen certificate of deposit maturities were lengthened and the credit rating system for Eurobonds was upgraded.

- In June 1986 foreign banks received permission to issue Eurobonds.

- In November 1987 Euroyen commercial paper issues were permitted for nonresidents. Guidelines for issuing Euroyen and domestic commercial paper by nonresidents of Japan were relaxed in December 1988.

All these changes had the effect of making it easier for Japanese savings to meet the overseas demand for funds, often in the Euromarkets of London and elsewhere where regulations were minimal, operating costs low and spreads thin -- a vast difference from the days prior to 1971 when Japanese individuals and institutions could not buy non-Japanese securities denominated in a currency other than yen.[2]

Changes in the Foreign Exchange and Foreign Trade Control Law and other liberalization measures generally made it easier for non-Japanese to invest in Japan as well as for Japanese to invest outside Japan. For Japanese corporations these changes meant they now had much more freedom than previously to raise funds on international capital markets to finance their activities in Japan or elsewhere. Japanese firms have responded enthusiastically to this opportunity. For example, between April and September of this year they reportedly raised as much as half their funds in the Eurobond and other offshore bond markets (see JEI Report No. 41B, October 27, 1989).

To the extent that the liability side of their balance sheet is in overseas currencies, Japanese firms may want to avoid currency risks by diversifying their assets out of yen as well, giving overseas activity still another push. As Japanese banks and securities companies have set up offices abroad and increasingly participate in London and New York financial markets, individual and institutional investors have gained additional channels for investing overseas, whether or not the original purpose of the banks or brokerage houses was mainly to facilitate capital flows from Japan.

In sum, during recent years regulations have been relaxed continually, making investment abroad much easier for Japanese firms and individuals, primarily by widening the choice of vehicles that can be used. But the response of institutional and corporate investors to deregulation has been relatively subdued in some instances. As large players Japanese banks and insurance companies may not want to risk disruption of international markets should they suddenly enter at the permitted level. For example, after 1986 the Finance Ministry allowed Japanese insurance companies to invest 30 percent of their assets overseas, up from 25 percent previously and 10 percent less than two years earlier. However, while the growth in foreign assets has been rapid since 1986, insurance companies appear to be well under even the 25 percent figure that was

[2]Yoshio Terasawa, "Comment on 'Opening Japanese Financial Markets: What Has Changed, What Will Change'" in Thomas A. Pugel (ed.), Fragile Interdependence (Lexington, Massachusetts: Lexington Books, 1986), p. 138.

permitted immediately prior to the 1986 liberalization. In some instances, of course, deregulation has advanced to the point where the remaining rules are no longer binding; Japanese firms simply may not want to invest as much abroad as the government allows.

Components of Japan's Foreign Assets and Liabilities

The regulatory changes affecting foreign capital flows imply that the composition of Japan's foreign assets and liabilities probably has changed. That, in fact, has been the case, as shown in Tables 3 and 4. The government accounted for most of the net position in the 1970s, in part a consequence of still restricted private capital flows. In recent years private investment has played a greater role.

Table 3: Japan's Net External Assets

(in millions of dollars)

End of Year	Private Sector	Government Sector	Total
1972	$-6,820	$20,687	$13,867
1973	-3,021	16,037	13,016
1974	-8,318	17,261	8,943
1975	-10,302	17,320	7,018
1976	-11,653	21,227	9,574
1977	-6,182	28,162	21,980
1978	-2,550	38,764	36,214
1979	850	27,927	28,777
1980	-16,659	28,193	11,534
1981	-18,537	29,455	10,918
1982	2,046	22,636	24,682
1983	11,928	25,331	37,259
1984	47,069	27,277	74,346
1985	104,450	25,371	129,821
1986	138,541	41,810	180,351
1987	146,494	94,250	240,744
1988	147,571	144,175	291,746

Source: Bank of Japan, Balance of Payments Monthly, April 1989.

A striking characteristic of the 1988 data is the surge in short-term private borrowing by Japanese banks (represented in Table 4 as short-term private monetary movements), which widened the already enormous private net short-term liability position. Japanese banks and other firms have increased their short-term borrowing in the Euromarket and elsewhere. As a result, private net assets hardly increased in 1988 (Table 3), despite the continued growth of long-term private assets, such as securities and direct investment, the two most publicly discussed dimensions of Japan's overseas net asset position. The government boosted its net asset position dramatically by lending to developing countries and increasing its foreign reserves, which account for the bulk of short-term government monetary movements in Table 4.

Table 4: Japan's External Assets and Liabilities

(in millions of dollars)

	Assets		Liabilities	
	End of 1987	End of 1988	End of 1987	End of 1988
Long-Term	$646,181	$832,669	$236,181	$311,625
Private Sector	565,100	728,168	178,810	268,431
Direct Investments	77,022	110,780	9,018	10,416
Trade Credits	37,189	48,791	35	23
Loans	97,469	123,663	1,101	1,061
Securities	339,677	427,218	166,206	254,886
Others	13,743	17,716	2,450	2,045
Government Sector	81,081	104,501	57,371	43,194
Loans	43,145	55,570	47	26
Others	37,936	48,931	57,324	43,168
Short-Term	425,450	636,678	594,706	865,976
Private Sector	343,261	538,802	583,057	850,968
Monetary Movements	320,171	502,256	530,072	765,165
Others	23,090	36,546	52,985	85,803
Government Sector	82,189	97,876	11,649	15,008
Monetary Movements	82,175	97,869	3,922	5,144
Others	14	7	7,727	9,864
Total	1,071,631	1,469,347	830,887	1,177,601

Source: Bank of Japan, Balance of Payments Monthly, April 1989.

Japan's Role as an Owner of Assets in the United States

Not surprisingly, Japan accounts for a significant portion of this country's net international indebtedness. Table 5, based on U.S. data and therefore not comparable to Tables 3 and 4, shows this result. (The Bank of Japan does not publish comparable data.) Japan's assets in the United States have topped U.S. assets in that country since 1983, but its percentage of the U.S. net debtor position peaked in 1985. At the same time the net figures hide the very substantial increase in U.S. assets in Japan. Between 1981 and 1988 the number more than tripled, jumping from $43 billion to $156.3 billion. Most U.S. assets in Japan are interbank claims resulting from, for example, the transfer of funds by a U.S. bank to its office in Tokyo.

For policymakers a key question is the extent to which these assets in the United States and Japan are potentially "footloose" and liable to be withdrawn on short notice. While the data suggest that this concern could be bilateral, the principal fear seems to be among Americans that Japanese investors will withdraw funds from the United States, throwing a supply of dollars onto world currency markets with disastrous consequences for the value of the American currency and for U.S. interest rates, which would rise.

Unfortunately, neither the Commerce Department nor the Bank of Japan publishes data on what is arguably one of the most volatile dimensions of

Table 5: U.S. Net Asset Position with Japan

(in billions of dollars)

	Japanese Assets in the United States	U.S. Assets in Japan	Net U.S. Position with Japan	Overall Net U.S. Position
1973	$14.3	$12.3	$-2.0	$47.9
1974	16.8	18.9	2.0	58.7
1975	16.4	17.4	0.9	74.2
1976	20.4	18.2	-2.1	83.6
1977	26.5	17.7	-8.8	72.7
1978	39.9	23.5	-16.5	76.1
1979	28.0	29.4	1.4	94.5
1980	35.3	37.4	2.1	106.3
1981	44.7	43.0	-1.7	140.9
1982	43.4	44.8	1.4	136.7
1983	50.1	48.4	-1.7	89.0
1984	67.6	48.3	-19.3	3.3
1985	101.1	56.1	-45.0	-111.4
1986	156.2	91.9	-64.3	-267.8
1987	197.7	113.4	-84.3	-378.3
1988	284.8	156.3	-128.5	-532.5

Source: Department of Commerce

Japanese investment in the United States, the purchase of Treasury bills and other short-term instruments. Note, however, that Japan's net worldwide position in private short-term instruments is negative (Table 4), suggesting that any concerns involving short-term instruments really should be bilateral.

Table 6 shows Bank of Japan data for the flow of long-term funds of various kinds into the U.S. market. Japanese long-term investment of all kinds in the United States has shown explosive growth. But direct investment -- where the foreign investor is considered an owner -- has grown more rapidly than portfolio investment, where the overseas investor takes a more passive, and potentially footloose, position in a company's stocks or bonds or long-term U.S. government securities. Based on the cumulative effect of the flows shown in Table 6, however, the stock of portfolio investment probably is still far larger than the comparable figure for Japanese direct investment.

The published Japanese data do not break down investment in the United States by stocks, bonds and government securities. Department of the Treasury data, which include purchases of marketable Treasury notes and bonds by foreign governments, show tremendous year-to-year variation in the pattern of Japanese purchases between 1985 and the first six months of 1989. For example, Japanese investors bought a mere net $300 million in U.S. stocks in 1985, but $3.3 billion the following year and $11.4 billion in 1987. Presumably reflecting hesitancy after the stock market crash in October 1987, net purchases dropped to $1.9 billion in 1988 and only $400 million during the first six months of this year. Treasury bonds and notes varied from an astounding 76 percent of total Japanese investment in long-term securities in 1985 to a negligible percentage

Table 6: Japan's Long-Term Capital Outflows to the United States

(in billions of dollars)

	Direct Investment	Trade Credits	Loans	Securities	Other	Total
1978	$0.8	$0.0	$0.0	$1.5	$0.3	$2.6
1979	0.9	0.0	0.6	0.6	0.0	2.2
1980	0.8	0.0	0.3	-1.6	0.0	-0.3
1981	1.9	0.0	0.2	1.5	0.4	4.1
1982	1.6	0.8	0.1	0.6	0.5	3.6
1983	1.3	0.2	0.3	5.0	0.2	7.1
1984	3.1	0.2	0.4	11.3	0.4	15.4
1985	2.5	0.6	0.7	31.6	0.0	35.4
1986	8.0	0.3	0.6	49.4	0.9	59.2
1987	9.6	0.5	1.5	37.4	1.6	50.6
1988	19.0	1.0	2.8	36.2	2.5	61.5

Source: Bank of Japan

the following year before rebounding to intermediate levels in the most recent years.

The year-to-year variation in Japanese investment does raise questions, of course, but all investors, foreign and domestic, move into and out of markets with increasing frequency. As comparatively small players in U.S. equity and corporate bond markets (Western Europe, for example, outnumbers Japan by a 5-1 margin in holdings of U.S. equities), Japanese investors' potential threat in these securities markets would appear relatively small. And, at least during the critical period immediately following the 1987 stock market crash, Japanese investors apparently were more patient than some others. The Treasury data show that between October and December 1987, foreign investors pulled a net $7.2 billion off Wall Street, led by the United Kingdom, which accounted for $5 billion of the total. But Japanese investors added $1.9 billion to their holdings, the only large group of international investors to take this action. (This move, by the way, proves that the majority is not always right. The subsequent run-up of the dollar and the recovery of the stock market suggest the Japanese action was a profitable one, especially if the investors cashed in some time in mid-1989.)

Taken together, the Japanese and the U.S. data imply that the role of Japanese funds in the United States has increased tremendously in recent years. That, in turn, suggests increased Japanese influence over the U.S. financial system. But that influence is still remarkably small. Even with the rapid increase in Japanese investment in America, Japanese and other foreign investors own a relatively small part of U.S. financial assets, where their holdings are still mainly concentrated. According to Federal Reserve Board data that do not break out ownership by country, foreign investors owned 5.7 percent of all U.S. financial assets in 1986, up from 4 percent five years earlier. The increase largely was accounted for by the run-up in the U.S. federal debt, which more than doubled in size during the period. However, foreign investors held 14.8 percent of all Treasury securities, which actually was down from 17.1 percent in 1981.

For some of the Federal Reserve Board categories, the Commerce Department provides a breakout by country. Overall, Japan claimed 15.9 percent of foreign assets in this country in 1988, but for some types of assets the figure was far lower. Japan's share of foreign-owned stock came to only 9.4 percent, suggesting that, since foreign investors account for approximately 5 percent of the total, under one-half of 1 percent of U.S. stock is held by Japanese investors.

Many casual observers of the real estate market, especially in some of America's largest cities, would suggest that this industry is an exception to the pattern of relatively low Japanese investment. While the data are sketchy, that apparently is not the case. The National Association of Realtors, a private group, estimated in 1989 that, as of 1986, only 1.5 percent of all U.S. commercial real estate and an even smaller 1 percent of farmland, was in foreign hands. Commerce Department data suggest that no more than 31 percent of foreign-owned property is Japanese, suggesting that Japanese ownership of real estate -- probably less than half a percent -- is about the same as it is of U.S. stocks.

Japan's Net Creditor Position and its Role in the World Economy

While the position of Japanese investors in the United States is important, ultimately the significance of Japan being a net international creditor is likely to lie in the ways in which it has already reshaped and will continue to alter the world financial system. Fundamentally, Japan's position as a net creditor means that the Japanese government and corporations are in the position of lending money to the rest of the world, either by buying Treasury securities in the United States or Eurobonds in London issued by nations or firms almost everywhere, lending money to refinance Third World debt or in other ways. While the United States and other countries may have net capital flows to some other parts of the world, Japan's net creditor position, assuming it continues, means that Japan will be the leading financier in more cases than not.

The demand for capital around the world is great. The huge U.S. budget deficit has been mentioned. In terms of the effect on the borrowing economy, however, Japanese international lending may be most important in Third World countries like Brazil and Mexico. In many respects the emergence of Japan as such a large net creditor is fortunate for these countries even though outstanding Japanese bank and official loans to the Third World are still modest compared with those from Washington and from American banks. With the United States absorbing a high proportion of international capital flows, interest rates throughout the world are somewhat higher than they would be otherwise, making the problems of Third World countries all the more desperate. Japan's ability to provide funds has had a countervailing effect on international interest rates, whether or not the Japanese government or Japanese banks actually extend funds to less developed countries. In this sense, the United States has been among the bad boys of international finance and Japan a good boy.

Historically, net lenders bring to the international financial system two players: their banks and their currency. In Japan's case the first has clearly arrived and the second may be on its way. Creditors obviously want to monitor their lending carefully and for that reason want to be close to it. Partly for this reason, Americans should not be surprised to see not only Japanese banks but Japanese brokerage houses and insurance companies at the heart of the action in U.S. financial markets.

The relationship between a large creditor position and the international use of the yen is a little more complicated. In many respects the postwar international economic system has been set up with the dollar as the centerpiece. Given the convenience of a single currency for denominating international transactions, for example, the dollar has maintained its position despite the relative decline of the United States in other respects. But a larger role for the yen is virtually inevitable. Japanese international investors, for example, want protection from currency fluctuations since their stockholders or policyholders expect their returns in yen. Japanese life insurance companies, which took a bath on their dollar-denominated assets when the dollar plummeted, are a case in point. This suggests a likely increase in short- and long-term securities that are tied to the yen.

Full internationalization of the yen would involve much more than yen-denominated bonds or other lending. The pros and cons of such measures as yen-denominated foreign currency reserves, however, would take the discussion far beyond this examination of Japan's role as an international creditor.

Japan in a Multipolar Economic World

Even if the dollar should remain the principal world currency, Japan's continued role as an international creditor raises questions about world economic leadership in financial markets. In the postwar period the United States clearly has played that role. Many experts believe that Japan is working behind-the-scenes to increase its influence. For example, some analysts speculate that Tokyo would like a Japanese national to be the next managing director of the International Monetary Fund, a post that traditionally has gone to a European. (An American traditionally heads the IMF's sister institution, the World Bank.) The term of the current IMF managing director, Michel Camdessus of France, expires in January 1992. Such a move would not directly threaten American preeminence, but can Tokyo gain influence without pushing the United States aside and still have a workable international financial system? Yes, but shared leadership has its own dangers.

The world economic system can be compared to a a hazardous waterway with a publicly financed coast guard providing emergency services. When major banks or other financial institutions navigating this waterway find themselves in a particularly dangerous section that jeopardizes both themselves and the stability of the international financial system, the coast guard does its work. In the past the Department of the Treasury has coordinated such rescue operations even when relatively little U.S. government money was at stake. Washington has been willing to play this role for multiple reasons: the banks or other threatened institutions have been largely American, the financial system -- not just individual banks -- has been believed to be at risk and the crisis often has involved countries with strategic political importance for this country. In addition, the solutions often have involved leaning on American financial institutions for help.

The Third World debt problem, which first received public recognition in 1982, provides one example. The situation has reached crisis proportions when banks have appeared to be at risk if they did not get prompt payment from their Third World borrowers. But Washington also believes the interest burden of the debt has posed a threat to economies in the Third World, which in turn affects U.S. political and military interests. Solutions, at least until recently,

often have involved additional lending. The Treasury and bank committees dominated by U.S. banks have been the leaders in cobbling together solutions, even in 1989 after a Japanese initiative, associated with former Finance Minister Kiichi Miyazawa, on Third World debt appeared to be giving Tokyo and Japanese banks a higher profile.

Compare this situation to one where the lending banks are mostly Japanese and European. The value of providing "coast guard" services is no longer so obvious to Washington. But Tokyo and others may not have an overwhelming reason to replace Washington in that role if, as would be likely, their banks and politicians have merely a fraction of the economic, strategic and political interests that have been crucial to America's motivations. Nor would having multiple "coast guards" make much sense. Diversified efforts could result in too many boats swamping the rescue if efforts were not carefully coordinated, and coordination might prove impossible in an emergency.

The global stock market collapse in October 1987 provides another example, relating to both causes and the responses to it. While theories abound about why stock prices tumbled around the world, one argument has to do with higher European interest rates sending a scare through Wall Street, in part because the new rates were seen as undermining economic policy coordination among the Group of Seven industrial countries. In short, the multiple, coordinated coast guard action was regarded as a failure. But, in at least one respect, Washington did come to the rescue, at least domestically after the crash, by providing liquidity to U.S. financial firms that faced large withdrawals. This action has been seen as instrumental in preventing a worse disaster. Many U.S. analysts credit the Ministry of Finance with an effective rescue of the Tokyo market, which also crashed.

Despite increasing participation from abroad, the stock markets in Japan and the United States still are dominated by domestic institutions and investors. However, equity and other financial markets are expected to become much more international in all dimensions in coming years, suggesting that the types of rescues effected in New York and Tokyo in 1987 may have been a last hurrah of sorts for national actions affecting primarily domestically owned financial institutions. Would the rescue on Wall Street have been as swift if the investors had been more mixed? What if many of the major banks pressed into service as part of the rescue team by the Federal Reserve Board and the Treasury had been Japanese- and European-owned? A more diversified group of investors may have diluted the interest of all concerned in responding to or orchestrating a rescue -- depending on the degree of self- or national interest that was involved.

The stock market example illustrates the need for new thinking on the role of global financial leadership. However, the debt crisis example suggests that like many other public services (police, fire protection, airplane traffic control) international financial coordination functions best when each of those receiving benefits is somehow convinced to make a contribution, financial or otherwise, in support of an established leader. In actions involving worldwide financial interests that leader in the past 40 years or so has been the United States. Such a system is likely to continue and to be viable provided each participant can see the benefit to itself and is generous enough to make a commensurate contribution when asked. Continued success depends on each contributor being committed to preserving the financial system. In addition, in a system

where the economic, political and strategic forces are not propelled by any one nation, only a leader that understands and accepts the needs of each of the participants will receive continued support.

This may be the evolving system. By virtue of experience, if nothing else, the United States has continued to play the role of "coast guard" in Third World debt issues and other international financial emergencies. But, as witnessed by Japan's unique financial contribution toward the hoped-for success of the Brady Plan, named predictably enough after the current treasury secretary, other countries -- including Japan -- play important roles in helping to make the rescues financially and politically viable. For its part, if Washington is to be the commandant of this global coast guard, it will have to be alert to the interests of each of the parties. In particular, it will have to recognize that Tokyo's priorities will sometimes conflict with its own, and it must be willing to subordinate its own interests. An effort to establish a system based on "Japanese money, U.S. control" is certain to lead to a non-American commandant and is most likely doomed to failure if the new leadership lacks the necessary international perspective.

Some analysts believe that Tokyo does not really relish global economic leadership. R. Taggart Murphy, a managing director of an American bank subsidiary in Tokyo and an affiliate of the U.S.-Japan Relations Program at Harvard University, is among those who see Japan as unsuited and unwilling to play a leading role. He writes:

> For all of its success at managing its own economy, however, Japan lacks the ideology and political commitment necessary to fulfill the obligations that go with financial power. To turn sheer financial strength into leadership, a country must be able to think in global terms, to view itself as a world central banker, to sacrifice certain short-term gains to maintain stable financial and trading systems. Japan does not have this world view. It holds the rest of the world at arm's length, and that separateness prevents Japan from assuming some of the important mandates of world financial leadership.[3]

Other Japanese and American analysts might question Taggart's implicit argument that Japan cannot grow into a new political role, just as it has economically. Taggart simply may be describing the reality that Japan still does not have as much at stake as the United States traditionally has had in world financial markets. If so, the kind of "coast guard commandant role" outlined above for the United States would be appropriate.

Conclusion

Japan's emergence as the world's largest international creditor has not yet brought in its wake profound political or economic change to the world financial system. Some such recalibration of that system, though, already has occurred and is likely to continue.

[3]R. Taggart Murphy, "Power Without Purpose: The Crisis of Japan's Global Financial Dominance," Harvard Business Review (March-April 1989), p. 74.

For Americans and those living in Third World countries, Japan's position is something of a godsend, relieving unwanted pressures on interest rates and living standards. In addition, Japanese investment in the United States may permit a larger increase in capital spending in this country than otherwise would be possible, thereby enhancing the competitiveness of American firms compared to Japanese companies and other rivals overseas. The immediate price for Americans is that Japanese and other foreign investors own a slightly larger part of the U.S. economy than they did before. In addition, potentially "footloose" inbound and outbound capital flows involving Japan raise new questions about the stability of exchange rates and international financial markets.

Some analysts believe Japanese firms will be motivated to repatriate at least a portion of their foreign investments early in the next century, if not sooner, in response to the rising needs in Japan of an aging population. Japanese and other investors have a right, of course, to repatriate their profits and even their original investments to their home country. Should this happen, U.S. living standards would have to fall for exports to rise unless total production simultaneously increased here. Given the small percentage of foreign ownership in this country, such a reduction in living standards probably would be modest. However, mounting U.S. debt increases the eventual cost of this adjustment every year.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.